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Private Equity

CHINESE COMPANIES AS INVESTMENT OPPORTUNITIES

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The life cycle of many businesses includes obtaining outside investors or a joint venture partner and eventually selling the business.

The majority of U.S. companies' investors, buyers and joint venturers are other U.S. companies, although a significant number are Canadian and European.

However, a growing trend is the emergence of Chinese companies in U.S. corporate transactions. Accordingly, in addition to contacting customary sources, U.S. companies can benefit by exploring transactions with Chinese companies. Doing so may enhance competition for the transaction and the transaction value, and in appropriate circumstances Chinese parties may offer the most attractive deal terms.

Chinese outbound deals are part of many Chinese companies' business plans, and "appropriate" deals receive Chinese government approval. Outbound Chinese deals commenced primarily with acquisitions of natural resources, raw materials and energy supplies, largely in Africa, but also in Australia and Canada. Reliable data regarding the magnitude of China outbound deals is limited, but clearly over the last several years outbound deals have been consummated in many other fields and geographic regions. Their growth rate is also increasing, including in the U.S. Chinese outbound transactions in the U.S. have occurred in a variety of industries, including apparel, automotive parts and parts supplies, airplane manufacturing, medical devices, the Internet, consulting and real estate. Most have been middle-market deals.

There are a number of factors that have facilitated and will result in further China deals in developed nations: the worldwide economic downturn; China's favorable export balance; its supply of foreign currency, especially U.S. dollars; many of its businesses' strong balance sheets; and those businesses' interests in investing in politically and economically stable countries.

Some Chinese corporate transactions are purely for financial reasons. A Chinese company may deploy excess cash in U.S. real estate, solely for the potential return. However, most Chinese outbound transactions are strategic, such as to acquire or license China rights for a product, brand or technology, or obtain access to research and development and intellectual capital. Also, a U.S. company's distribution network can be used to distribute the Chinese company's goods in the U.S., rather than trying to establish its own distribution network. Such transactions can assist in establishing or furthering global brands and in gaining market share.

The Chinese government supports outbound transactions as per its recently adopted 12th Five-Year Plan, which states, in part:

"We will guide enterprises ... to engage in overseas investment ... in an orderly manner based on the market-oriented principle and ... independent decision-making by enterprises; ... support the overseas investment ... encourage the advantageous manufacturing enterprises to make effective overseas investment, and build international marketing networks and well-known brands; ... strengthen [support] for ... the 'go global' strategy; ... and improve the promotion system of overseas investment and facilitation of enterprises' overseas investment. ... China's "go global" enterprises and overseas cooperative projects will fulfill their social responsibility and benefit the local people."

All Chinese outbound deals had required national government approval, but now many require only provincial approval, purportedly resulting in a faster process. Support for outbound transactions is especially strong for seven strategically important sectors: energy efficiency and environmental protection; next-generation information technology; pharma and biotech; high-end manufacturing; new energy; new materials; and new energy automotive. The only recently reported outbound deal not to obtain Chinese approval was an attempt by Sichuan Tengzhong Heavy Industrial Machinery Co. Ltd. to buy General Motor Co.'s Hummer brand. Speculation is that the Chinese authorities did not view the buyer as appropriate, and according to The Wall Street Journal, the company did not even properly seek government approval.

U.S. deals should also be of particular appeal to the Chinese government due to its substantial dollar supply, although to date Europe has attracted more deals.

For a U.S. company exploring a corporate transaction, the participation of potential Chinese counterparties can offer several benefits. The involvement of additional parties generally should be beneficial in maximizing the transaction terms. Chinese companies often may view deals as fitting their business plans and strategic objectives, thus potentially enhancing their interest and price. The growing number of Chinese deals in the U.S. is evidence that such deals can be beneficial to the U.S. party.

In many respects a transaction with a Chinese company is similar to one with any foreign party; language, business and cultural differences can cause misunderstandings, and each party may have different expectations as to acceptable terms and the deal process. Moreover, Chinese management may lack experience in international dealmaking generally, have little or no U.S. deal experience and may have weaker English-language skills than other foreigners. Certainly these factors may make deals with a Chinese company slower and more difficult.

A U.S. company can seek to minimize the impact of these factors by engaging legal and other advisers with experience in transborder transactions and with Chinese companies. Another is to be as clear and precise as possible in communications, as even non-U.S. persons who speak excellent English may miss nuances.

Conversely, a U.S. company should seek to have the Chinese company make clear its positions and objectives. The U.S. company should also consider insisting that the Chinese party engage U.S. legal counsel and other U.S. advisers unless the Chinese party itself and/or its Chinese advisers demonstrate meaningful U.S. deal experience. A Chinese company with such expertise or U.S. advisers not only demonstrates a greater interest in a potential transaction, but these facts can facilitate matters by achieving a mutual understanding of market terms, avoiding or smoothing over misunderstandings and reducing negotiation over customary or boilerplate matters.

Particularly in the case of an acquisition, assuming the sellers are not receiving equity in the Chinese buyer or otherwise have a valid reason to be concerned about the Chinese buyer's business or financial condition, the due diligence by the U.S. company should be limited.

A transaction agreement with a Chinese company should not generally need to significantly differ from one involving any other counterparty. However, the U.S. company should seek advice from its legal counsel for issues such as the potential relevance of the Committee on Foreign Investment in the United States and issues involving certainty of payment and means to enforce rights and remedies.

Although generally applicable, U.S. regulatory requirements do not expressly distinguish between companies from different countries. There are as a practical matter potential differences, some positive and some negative. For example, the Hart-Scott-Rodino Act may often be less problematic with a Chinese counterparty.

CFIUS authorizes the president to suspend or prohibit a transaction when, in his judgment, there is credible evidence to believe that in such a transaction a foreigner controlling a U.S. business might take action that would threaten national security. However, national security should not be an issue for most industries. CFIUS does not distinguish among foreign countries, yet in reviewing proposed transactions for national security purposes, the government does appear to consider the foreign party's national origin. This could be the case for a Chinese buyer, especially if it is state-owned or if the target company's industry involves national security. However, as evidenced by completed deals, including purchases of an airplane manufacturer and suppliers to the U.S. auto industry, the situations where CFIUS finds an issue should generally be identifiable very early in any potential deal and in most cases should not pose a problem.

Regulated U.S. industries may require additional approvals. In some cases, such as a proposed Chinese acquisition of a television or radio station, this may be problematic.

U.S. companies seeking capital, a joint venture partner or a buyer traditionally have not sought these from China. However, as Chinese companies are emerging as outbound cross-border players, U.S. companies and their advisers should look for opportunities to take advantage of this additional source of capital and additional bidders.

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